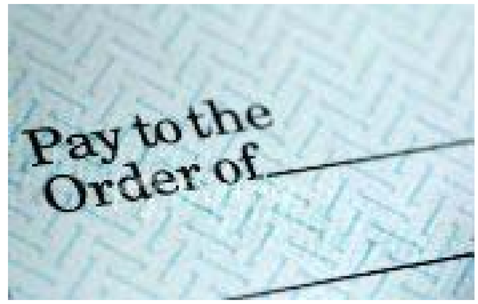
S-Corp Owners: Is Your Salary Reasonable?

By: Renee Daggett

IRS statistics show that business owners are choosing to form S corporations at an unprecedented rate – and with good reason.



After all, operating as an S corporation means that you can pass net profits to yourself without having to pay self-employment tax (Social Security, Medicare etc.) on the earnings. This is unlike partnerships or sole proprietorships, which must pay self-employment tax on every dollar of net profit they earn thus adding up to a hefty sum depending on how well your business has done for a particular year.

But remember, S corporations also have compliance issues that don't exist for other types of entities. One of those is called, "Reasonable Compensation." Perhaps one of the main reasons S corporations get audited these days is that they file a tax return with no amount showing for "Compensation of Officers." The IRS assumes that no one works for free. This means that officers of the corporation must receive "reasonable" wages. **You need to pay yourself a salary – and pay the accompanying payroll taxes on your salary.**

So what is a reasonable salary for an owner-officer of an S corporation?

The short answer is that it depends. It's a gray area of tax law that has long been the subject of disputes between the IRS and business owners. In many areas, specific rules exist for determining various amounts, but there is no such rule for reasonable compensation. In general, **here are some rules of thumb to follow when trying to determine what salary to pay yourself**.

- Use the same criteria to determine compensation of officers as you would for salary of non-shareholders. Think about what you would pay an employee of your company for the same position.
- Research market rates for typical salary ranges in your industry for your type of position. Evaluate how valuable your knowledge, skills and abilities are to the position.
- Take into account how many hours you normally work and what the prevailing rate per hour is for someone in your position.
- Factor in some standard rate of return such as a commission rate of percentage of profits.

Generally, the IRS will allow an S corporation some flexibility in setting salary compensation for owner-officers. But an auditor will use some or all of the factors mentioned to establish what he or she considers reasonable in the event of an audit.

So what is an unreasonable salary?

Zero would definitely be considered unreasonable...unless perhaps it is your first year in business and your S corporation has very little income. You probably could not talk a potential employee into accepting anything below minimum wage either. Also, any amount that is an unusually small percentage compared to the net income of the business is a red flag. For example, if you make $500,000 in net profit but pay yourself a salary of only $10,000, it will not seem reasonable.

Realize that the IRS wants to collect payroll taxes on your salary, so it is in their best interest to maximize compensation at a reasonable rate. They know that many S corporations may try to avoid or minimize payroll taxes by paying officers low wages. Beware…the IRS can slap a penalty on you for failing to pay payroll taxes of 100% of the taxes owed.

The solution is simple: Pay yourself a salary that is reasonable compensation for your position in your industry. It's the safest business decision you can make.

If you're still unsure about how much to pay yourself, Admin Books can help. Call or email us to discuss your options.

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